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Opening address

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Good morning,

I would like to thank Deloitte, Sociedad de Tasación and ABC for inviting me to inaugurate this 26th Financial Sector Meeting, which represents a unique opportunity to debate the present and the future of the sector.

A look at the agenda for this event reveals that the words “challenge” and “opportunity” appear in the title of virtually every presentation. My speech will hardly be original, as it will focus precisely on the opportunities and challenges facing the banking sector in Spain.

First, I will discuss the actions that the banks have been taking for some time now, not without pressure from the supervisor, which have led to improvements in both solvency and profitability. I will then take a more forward-looking view, focusing on the measures that I believe must be implemented in order to capitalise on the opportunities and address the challenges.

Looking back

It would be fair to point out that in the last five years Spanish banks have undertaken a thorough balance-sheet clean-up, with recapitalisation and restructuring. This has markedly improved the industry’s position in terms of basic parameters, such as asset quality or levels of profitability and solvency.

Indeed, the reduction in non-performing loans and foreclosed real estate assets between December 2013 and the end of 2018 was very considerable. Private-sector non-performing loans fell by 60% from their peak in 2013.

Foreclosed assets followed a similar trend, declining 40% from the high ebb of 2012, although the bulk of this reduction took place over the last two years. In particular, major strides were made in this connection during 2018, when Spanish banks very actively sold off portfolios of impaired assets and foreclosed real estate, leading to asset quality improvements and management cost savings.

The volume of non-performing assets is being reduced at a similar pace to that observed during the recovery from the previous crisis, which began in 1994. Thanks to these efforts, as at December 2018 the average level of non-performing loans (NPLs) stood at the average for European Union countries.

The economic recovery has contributed to this process, but, as I have mentioned, the reduction in non-productive assets has largely been driven by the credit institutions’ active management. It should not be forgotten, however, that this active management has been, to put it mildly, “encouraged” by the supervisor.

Specifically, the Single Supervisory Mechanism (SSM) established and announced its supervisory expectations by publishing supervisory guidance in March 2017. That guidance was supplemented a year later with an addendum. On the basis of these expectations, each bank has set out an ambitious but credible strategy for the divestment of non-productive assets.

In addition to reducing non-productive assets, there have also been profitability gains at Spanish banks. Following the slump of 2012, when profitability stood in negative terrain (reaching -25%), in 2018 return on equity stood at 8.5%, well above the euro area average of 6.9%.

For its part, return on total assets reached 0.6% in 2018, likewise above the average of 0.5% for all banks under the supervision of the SSM.

Although profitability has returned to positive values and stands above the European Union average, it remains below pre-crisis levels and short of the cost of capital required by investors.

The low average profitability generated by Spanish banks is especially apparent in their business in Spain. Several factors are behind this low profitability.

First, the still-high volume of non-productive assets has a direct negative bearing on banks' income statements by driving down the interest earned, while increasing impairment provisioning and the costs associated with the maintenance and management of these assets. In fact, comparing the 2015-2017 period with 2003-2005, we see that the decline in net profit for the business in Spain was essentially due to impairment losses.

Second, the current levels of interest rates have squeezed banks' net interest income. Lastly, the low level of profitability is also explained by the significant drop in income associated with private-sector deleveraging. Indeed, it is estimated that two thirds of the decline in net interest income in Spain is due to the contraction of credit.

As for costs, the drive to adjust operating capacity is notable, and has allowed operating expenses to remain on a downward path in recent years. As is common knowledge, this adjustment in operating capacity took the form of a significant reduction in staff and branch numbers in Spain. From the peak recorded in 2008, branch numbers have been reduced by more than 40%, while staff numbers are down by well over 30%.

The international business, essentially that of our two top banks, has enabled higher profitability. However, this comes with its own challenges, as evidenced by the recent difficulties in some of the emerging economies to which our banks are exposed.

Despite these difficulties, the geographical diversification of banks is a source of added value and of medium and long-term stability. The low correlation of activity between countries ensures more recurrent income that is less exposed to isolated crises. Moreover, because banking markets in emerging countries are less mature, our international banks have been able to secure wider margins.

In terms of solvency, I have already indicated that Spanish banks have likewise shored up their capital levels. Specifically, the average CET1 ratio has shifted from levels of 9.8% in 2014 to 11.5% in 2018.

While this is a clear improvement, the fact is Spanish banks would rank last in a hypothetical European league table of average solvency levels. Indeed, the gap between the average CET1 ratio for Spanish banks and that for the EU has shifted from 200 to 300 basis points

in the last four years, meaning that European banks have strengthened their capital comparatively more than Spanish banks.

However, in terms of leverage, Spanish banks stand in a stronger position than the European average, particularly set against Spain's "comparable" European peers (i.e. the United Kingdom, France, Holland, Germany and Italy). This lower leverage has been maintained since 2016, although the gap against the European average has decreased.

There are several reasons for this "divergence" in the league table of solvency levels, measured in terms of leverage and capital ratios. First, we should bear in mind that during the crisis some credit segments in the Spanish market performed relatively worse than others; second, more capital being allocated to assets in certain economies drives up the requirements for our two top international banks.

In addition, the greater relative density of risk-weighted assets (RWAs) is associated with limited use of internal models for consumption of capital, as compared with other euro area countries.

One positive consequence of this limited use of internal models is that the requirements are less cyclical. It also means that, unlike other European competitors, Spanish banks will not be affected by the future introduction of capital floors based on the standardised approach established in Basel II.

Consequently, although Spanish banks need to shore up their capital ratios, it should be noted that they have certain comparative strengths in terms of leverage and geographical and economic diversification.

Looking ahead

Allow me to now turn to the challenges that I believe our financial system must address in order to remain profitable, against a background of growing regulatory demands and competitive pressure.

Reducing non-productive assets

As I have said, it is fair to point out that Spanish banks very actively sold off portfolios of impaired assets and foreclosed real estate during 2018, leading to asset quality improvements and management cost savings.

Even so, according to the Banco de España's internal estimates, in 2020 the NPL ratio may still stand close to 4%, in the absence of wholesale portfolio sales.

The average coverage ratio for non-productive assets as a whole has likewise declined, from levels of close to 45% in late 2013 to below 39% at the end of last year.

Restoring profitability

As I have mentioned, improving profitability, and the long-term sustainability thereof, is one of the main challenges facing the sector in the future.

The correction in levels of impaired assets that I referred to moments ago is key: as well as shoring up solvency, it will open up several avenues of profitability improvement. First, resources currently devoted to financing non-productive assets will be freed up. Second, all costs associated with portfolio maintenance will be eliminated. Such costs can be particularly burdensome for real estate assets. Third, it will allow activity to be refocused towards profitable business.

Thus, reducing non-productive assets remains a challenge for the sector, but at the same time is an opportunity to improve solvency and profitability. It is no surprise that the SSM's supervisory priorities for this year again include the requirement that banks persevere with asset management policies.

With respect to cost reduction, the charts illustrate how the sector has scaled down its operating structure very significantly over the last 10 years. Nonetheless, banks in Spain continue to have clearly higher branch numbers than banks in the euro area and other economies. Consequently, this avenue still offers some potential for cost reduction.

By contrast, Spanish banks present the lowest staff numbers per 100,000 inhabitants among comparable European countries, while internationally they are bettered only by Japan. This is a reflection of the high number of branches with few employees at our banks, as a result of population dispersion.

The risk of financial exclusion is a topical issue, and the closure of bank branches in small, sparsely populated areas is evidently viewed as a matter of concern.

However, I would stress that wider use of mobile and Internet banking, and mobile applications in general, would help to head off this risk and mitigate its effects. As the chart shows, according to OECD data we have enormous potential in this regard.

In any event, it is important to note that Spanish banks fare comparatively better in terms of cost efficiency than banks in other European countries, particularly looking at the results for the main European economies, such as Germany, France, United Kingdom and Italy.

A business model for the future

Given the current interest rate environment, together with the emergence of new technologies and of new non-bank competitors (fintech and bigtech), banks must evaluate and adapt their strategy and business model with a view to setting medium and long-term targets that enable them to generate recurrent results.

Each bank is starting out from a very different position, and therefore each must find its own way. In fact, a recent thematic review by the SSM on profitability and business models demonstrated that there is no single optimal business model in terms of profitability and solvency. According to the review, the most profitable banks apply very different business models. Consequently, each bank must evaluate its strengths and potential areas for improvement.

Irrespective of what path they choose, it is of the utmost importance that banks always apply appropriate pricing policies for their products and services. These policies must be consistent, comprehensive and rigorous to ensure that the price charged for a product or

service covers at least its total cost, including the risk premium inherent in each type of transaction.

From the supervisory standpoint, it is essential to emphasise that the search for profitable business must not come at the expense of rigorous credit standards. Past experience has shown that loosening credit standards ultimately translates into notable increases in default rates. The importance of this matter is evidenced by the SSM's inclusion of a review of credit standards among its priorities for 2019.

The impact of technology

The impact of technology is a key consideration in the design of a future business model. I am saying nothing new when I point out that the emergence of new, flexible competitors with a low cost structure poses a threat to the traditional banking business model, as may become evident with the implementation of PSD2. However, no less certain is the fact that digitalisation and technological innovation bring fresh opportunities in terms of efficiency, accessibility and immediacy, as well as new businesses and more dynamic ways of engaging with customers.

As I mentioned earlier, Spanish banks still have large branch networks in relative terms and there is a great deal of potential for improving online or mobile access to banking services. Banks must therefore explore this avenue in order to continue to gain efficiency without losing customers, even if this entails investing in IT systems in the short term.

Their challenge is to adapt, which brings new risks, such as the over-dependence on solutions provided by the so-called “bigtech” firms. Small and medium-sized enterprises may have to evolve from more defensive positions to greater openness to collaborate with “fintech” companies.

Reputation and conduct

Another aspect to note regarding the future business model is the need to integrate a customer protection framework.

The current concern about conduct risk is well known, as illustrated by the fact that the number of complaints by customers to banks’ customer complaints services increased almost six-fold between 2014 and 2017. The volume of complaints received by the Banco de España, largely related to mortgage transactions, has also grown considerably.

Such complaints often point to banks’ inappropriate behaviour in the past towards their customers. However, to be fair, it should also be stressed that customer protection legislation has changed significantly in recent years, As a result, what was considered appropriate in the past is no longer acceptable.

Traditionally, legislation focused on ensuring that customers were properly informed and that they were able to express, at least formally, that they had understood and accepted the conditions to be applied.

The financial crisis has given rise to more demanding legislation that calls on banks not only to inform but also to act truthfully, impartially, transparently and professionally, taking into

account the rights, interests and needs of their customers. A good example of this new philosophy is the recent real estate credit law.

In my opinion, one very positive aspect of this new approach, which seeks to protect the customer, avoid conflicts of interest and promote genuine transparency in transactions, is precisely that it improves legal certainty and significantly reduces the risks of future litigation.

Let us not forget that litigation expenses are one of the main costs the industry has been bearing. I believe that customer protection, far from hindering the business and profitability of banks, is central to a banking business model that is viable and sustainable in the long term.

Also, taking legal action on complaints increases the workload and costs of the judicial system and is ultimately detrimental for the customers themselves, since the need to meet future legal costs inevitably raises the cost of credit.

I should stress that implementing this new approach to banks' relations with their customers requires a cultural shift, which will not be possible without firm support from within the organisation, starting with the board itself.

Improving the solvency ratio

Our solvency ratio is one of the lowest in the euro area. Regardless of the strengths and particularities which qualify and explain these objective data, the situation undeniably exerts pressure on our banks to improve their capital levels.

In order to shore up the solvency ratio, banks can obviously take measures addressing the numerator, by increasing capital, or the denominator, by seeking to reduce or limit the growth of RWAs.

Starting with the denominator, apart from discarding unprofitable business lines and reducing non-productive assets, as mentioned earlier, some banks are beginning to explore the possibility of using internal models.

Although one of the key explanations for the greater density of RWAs is associated with the limited use of internal models, banks must be aware that the supervisory requirements regarding the use of such models are very stringent. A good example of this is the TRIM (Targeted Review of Internal Models) project, which has involved the review, based on SSM methodology, of internal models to assess credit, market and counterparty risk applied in the euro area.

A key aspect to bear in mind is that the use of models implies undertaking significant improvements in risk management, data quality and the governance framework. Naturally, this process is far from straightforward and for some credit segments, an increase, rather than a decrease, in the consumption of capital cannot be ruled out.

As regards the numerator of the ratio, the clearest route to strengthening capital is through the organic generation of reserves, which leads me once again to highlight the importance of profitability and, in relation to profits, of dividend policy.

Dividend policies should take into account each bank's organic capital generation needs. In this respect, the variability of the average pay-out ratio in recent years is worth noting.

As can be observed, it rose significantly in 2017 to an average of 48%, but declined again to 41% last year.

To a large extent, the variability in the pay-out ratio is the result of banks' communication policies, with projections of dividends expressed in terms of money per share rather than in terms of pay-out.

It is worth noting that variable income is not the same as fixed income. This may sound obvious, but the fact is that the projections issued by banks often given rise to excessively rigid market expectations regarding the amount of dividend payments. The variability of profits should be reflected in the variability of dividends.

True, market expectations will always exist. However, we should not go the extreme of treating such expectations as quasi-contractual clauses. For example, recent situations have arisen in which it was taken for granted that banks would voluntarily replace certain issues with new ones, remunerated at a higher interest rate.

Obviously, opting to pay more for the same type of financing makes no sense whatsoever from a financial standpoint. There is much talk of "market discipline", but I believe that such discipline should work both ways. In my opinion, if it makes financial sense, then banks should "fall short of expectations" in order to discipline the market.

Mergers

In the context of the search for profitability and shoring up solvency, the subject of bank mergers will almost inevitably come up.

As has already been said many times, our role as supervisors is not to decide which mergers are desirable and which are not, but to assess the extent to which a merger process may lead to the creation of a more solvent institution, with a sound business model, enabling structural costs to be reduced significantly and, in short, overall value to be generated. It is important to note that mergers are lengthy and complex processes and that they can sometimes give rise to more problems than initially envisaged.

In any event, banks continue to have cumbersome cost structures, particularly when compared with new competitors, which base their business almost exclusively on mobile banking. Thus, in the current setting of low interest rates and high competition, mergers are a clear alternative for securing gains in efficiency and profitability.

It has been widely commented that, at least for now, mergers have only taken place at the national level. The absence of cross-border mergers is generally seen as a sign that the Banking Union is not working as it should.

We must recognise that several elements of the Banking Union are still not in place, including most notably the European Deposit Insurance Scheme (EDIS) and a bail-out fund with real capacity to act in the event of major banking crises. Also, the regulations affecting the sector are still too heterogeneous across the different jurisdictions, and certain European projects, such as the Capital Market Union, are still to be developed.

Nevertheless, without dismissing or ignoring these reasons, which would partly explain the lack of European consolidation, it seems that the very excess capacity of the banking sector is acting as an entry barrier to banks from other jurisdictions, given that the potential gain in costs and synergies can only be obtained in mergers between banks with overlapping networks and services, which almost only occurs in the case of banks in the same jurisdiction or those with a business model that allows vertical savings.

Governance

I would like to conclude by referring to the importance of banks' having proper governance frameworks.

The issue of governance has been on the agenda of international organisations for some time now. The OECD published the first corporate governance principles in 1999. The Basel Committee on Banking Supervision adapted the OECD Principles in 1999 and issued its own corporate governance principles in 2006, which it has subsequently revised several times, most recently in 2015. The SSM published recommendations on governance and risk appetite in June 2016.

Governance does not often make the newspaper headlines and is probably not among the main challenges facing the industry, to be discussed at this meeting today and tomorrow, but it is a precondition for the proper functioning of banks.

Throughout my address, I have talked about the need for transforming the business model of banks, for new policies on customer relations, the possibility of using internal models to improve risk management and consumption of capital, and so on. None of these measures are likely to succeed if governance is not assured.

Regrettably, we have seen the impact that structural weaknesses in the governance frameworks of some banks can have not only on the banks themselves, but on society as a whole. Thus, beyond complying with all the prudential ratios, I believe that establishing sound governance mechanisms in financial institutions is an essential precondition for ensuring their proper functioning in the future.

As you know, the issue of governance has gained prominence on the agenda of the SSM, which assesses different aspects of banks' internal governance. The findings of these reviews are not limited to merely making recommendations for improvement, but have a direct impact on the capital requirements arising from the supervisory review process.

Although significant progress has been made in recent years, I would like to highlight two areas where we must continue working: i) the functioning of boards; and ii) the implementation of risk appetite frameworks.

On boards, there is scope for improvement in terms of independence, dedication and succession planning. Many institutions have carried out self-assessments of how their board works, and have adopted measures accordingly, but more still needs to be done.

Specifically, boards must act as genuine control bodies, not only as the formal ratifiers of decisions taken at lower levels. They must also exercise effective oversight of managers. To this end, their composition must include individuals representing a broad range of profiles,

with experience and knowledge of the different technical matters on which resolutions are to be adopted. The quality of data and information on risks are naturally pivotal to determining strategy and decision-making.

Lastly, the risk function must be adequately represented on the board and carry weight in the bank's decision-making. In addition, work remains to be done on integrating the risk appetite framework into management.

Conclusions

To conclude, I would like to acknowledge what banks have achieved in recent years. The industry is far better off than five years ago as regards solvency, profitability and asset quality. However, as banks are well aware, there is no room for complacency.

The search for profitability, the reduction of non-productive assets and strengthening solvency will remain central issues in the coming years. In an increasingly competitive environment, improvements in management and cost rationalisation continue to be essential levers for improving solvency and profitability.

To meet these challenges, it is important that banks analyse their business models in depth so as to enhance their strengths and address any aspects that may hamper their viability in the medium term. A clear and ambitious response to technological change, along with a new customer-bank relations policy, should always form part of a viable and sustainable business model. Naturally, the implementation of profound changes in organisations will be destined for failure without a proper governance framework.

To paraphrase the title of this meeting, I am confident that banks and supervisors will do everything they can to help build today the banks of the future.

Thank you very much.